

QUARTERLY REPORT



OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan
County Executive

Bruce Romer
Chief Administrative Officer

November 15, 2004

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended September 30, 2004. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were 5,670 active members and 4,559 retirees participating in the ERS as of June 30, 2004.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of .41% compared to the benchmark index gain of .39%. For the one year period ending September 30, the ERS' gross return (before fees) was 13.07%, over 50 bpts. above the benchmark return of 12.55%. The strong one-year return places the ERS' performance in the top third of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. The outperformance continued through October 31 with the one-year return nearly 50 basis points above the benchmark index. The asset allocation at September 30, 2004 was: Domestic Equities 50.5%, International Equities 16.7%, Fixed Income 24.7%, TIPS 7.2%, Alternative Investments .5%, Cash .2% and Real Estate .2%.

Capital Markets and Economic Conditions

During the quarter, economic growth was stalled by a heightened fear of terrorism, a sharp increase in oil prices, and the worst hurricane season to hit the U.S. in 40 years. After averaging \$36.75 over the first half of this year, crude oil futures rallied to reach nearly \$50.00 by the end of September. With limited ability to pass along increases in input costs, producers either watched profitability deteriorate or reduced output. Another blow to the economy this quarter was the severity of the hurricane season. While the ultimate impact may be stimulative as rebuilding gets under way, these natural disasters will negatively impact economic statistics over the near term. The Federal Reserve maintained its program of measured tightening, raising the Fed Funds rate in two 1/4 point rate hikes to 1.75%. The press release issued at the September FOMC meeting signaled that the Fed would raise the funds rate again during the fourth quarter, barring a significant turn in economic data.

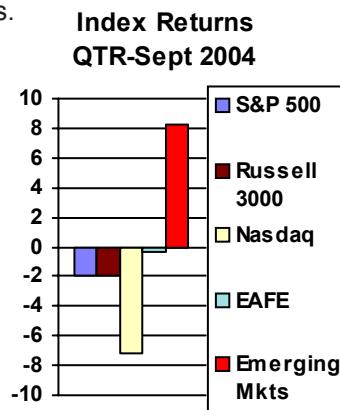
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Within global stock markets, as seen in the chart below, emerging markets outperformed developed ones. U.S. stock markets declined in the third quarter, and although U.S. companies generally reported good second-quarter earnings, guidance for future quarters was toned down. Information technology stocks fell amid concerns over rising inventories and a slowdown in PC sales from relatively high levels.

With the tech sector growing in only single digits, companies battled for market share and saw their stock price drop sharply on evidence of poor earnings. The best results for the quarter came from energy stocks, utilities and REITs which can be attributed to a continued low interest rate environment. Our combined domestic equity performance was a loss of 1.46% for the quarter, slightly better than the 1.90% loss recorded by the Russell 3000 benchmark index.

Internationally, the EAFE Index, comprised of developed markets, was down just .3% for the quarter compared to the 8.2% performance of the Emerging Markets Index. Returns for U.S. dollar-based investors were slightly enhanced by the dollar weakness against several currencies including the Canadian dollar, the euro and the Swiss franc. Our combined international equity performance was a gain of .84% for the quarter.

As the Fed continued its course of gradually raising rates during the quarter, the bond market rallied, sending the yield on the 10-year U.S. Treasury note down to 4.1% at quarter end, dropping .5% from the June 30, 2004 level. This contributed to a dramatic flattening of the yield curve, as the spread between the 12-month treasury bill and the 10-year treasury note dropped from over 250 basis points at the beginning of the quarter to approximately 200 basis points by quarter-end. The high yield market outperformed all of the major equity indices as well as investment grade corporates during the quarter. Credit spreads, which were already at historically low levels, continued to fall across the ratings spectrum. Our combined fixed income return for the quarter was a gain of 3.14% compared to the gain of 3.51% recorded by the benchmark index. ERS investments in Treasury Inflation Protection Securities (TIPS) recorded a gain of 3.22% for the quarter, outperforming the TIPS benchmark by 14 basis points.



Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending September 30, 2004 and fiscal year-to-date.

Employees' Retirement System Contributions and Investment Income (millions)

| | <u>Qtr 9/30/04</u> | <u>Fiscal YTD</u> |
|------------------------|------------------------|-----------------------|
| Employer Contributions | \$ 18.5 | \$ 18.5 |
| Member Contributions | 4.0 | 4.0 |
| Net Investment Income | <u>5.0</u> | <u>5.0</u> |
| | \$ 27.5 | \$ 27.5 |

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Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, administrative expenses and other costs.

Employees' Retirement System

Deductions by Type

| (millions) | QTR 9/30/04 | Fiscal YTD |
|-------------------------|------------------------|-----------------------|
| Benefits | \$ 28.4 | \$ 28.4 |
| Refunds | .1 | .1 |
| Administrative Expenses | .4 | .4 |
| | <hr/> \$ 28.9 | <hr/> \$ 28.9 |

Outlook

Economists expect the GDP to grow just over 3% during the fourth quarter and to continue at this pace through the new year. Improving economic data should reinforce the Fed's confidence in the sustainability of the current expansion and support the plan to gradually remove the accommodation from current monetary policy. The stability of interest rates and the flattening of the yield curve have likely convinced the FOMC that its strategy is on target. Profit growth is likely to slow significantly in response to reduced opportunities for cost cutting and the need for many sectors to absorb higher energy costs. The 12-month core CPI inflation should drift from around 1.7% currently, to near 2% by year end, again due to higher energy costs.

Major Initiatives

During the quarter, the Board received their annual report on brokerage fees paid by the System's domestic and international equity managers during the previous year. Overall, the System's trading costs (average commission paid in cents per share) ranked lower than 75% of other pension plans in the universe. The Board also completed the annual submission of the System's data for FY 04 to be included in the Montgomery Measures Up publication.

In addition, the Board completed a due diligence review of the System's current emerging markets manager and voted to begin a search for a replacement manager.

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EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF PLAN NET ASSETS

September 30, 2004

Assets

| | |
|--|----------------------|
| Equity in County's pooled cash and investments | <u>\$ 78,367</u> |
| Investments | |
| Northern Trust | 1,959,773,454 |
| Aetna | 9,785,416 |
| Fidelity - Elected Officials Plan | <u>590,327</u> |
| Total investments | <u>1,970,149,197</u> |
| Contributions receivable | 6,574,938 |
| Fixed assets, at cost: | |
| Office equipment | 111,375 |
| Less: accumulated depreciation | <u>111,375</u> |
| Net fixed assets | <u>-</u> |
| Total assets | <u>1,976,802,502</u> |

Liabilities

| | |
|--|-------------------------------|
| Benefits payable and other liabilities | <u>2,657,710</u> |
| Net assets held in trust for pension benefits | <u>\$1,974,144,792</u> |

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**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS**
September 30, 2004

| | Quarter | Fiscal YTD |
|--|-------------------------------|-------------------------------|
| Additions | | |
| Contributions | | |
| Employer | \$18,507,706 | \$ 18,507,706 |
| Members | <u>3,988,661</u> | <u>3,988,661</u> |
| Total contributions | <u>22,496,367</u> | <u>22,496,367</u> |
| Investment income | 6,670,198 | 6,670,198 |
| Less investment expenses | <u>1,694,727</u> | <u>1,694,727</u> |
| Net investment income | <u>4,975,471</u> | <u>4,975,471</u> |
| Total additions | <u>27,471,838</u> | <u>27,471,838</u> |
| Deductions | | |
| Retiree benefits | 21,774,474 | 21,774,474 |
| Disability benefits | 5,250,000 | 5,250,000 |
| Survivor benefits | 1,334,000 | 1,334,000 |
| Refunds | 145,593 | 145,593 |
| Administrative expenses | <u>441,950</u> | <u>441,950</u> |
| Total deductions | <u>28,946,017</u> | <u>28,946,017</u> |
| Net increase (decrease) | <u>(1,474,179)</u> | <u>(1,474,179)</u> |
| Net assets held in trust for pension benefits | | |
| Beginning of period | <u>1,975,618,971</u> | <u>1,975,618,971</u> |
| End of period | <u>\$1,974,144,792</u> | <u>\$1,974,144,792</u> |